DISCUSSION PAPER

ON

LIMITED LIABILITY COMPANIES

November 1999

Alberta Registries

Executive Summary

This paper explores the potential to create Limited Liability Companies (LLC) in Alberta. It assesses whether LLCs would be a desirable business vehicle for closely held Canadian - controlled Alberta businesses. It also examines whether LLCs would further the US tax objectives of American firms carrying on business in Alberta.

It appears that LLCs may be of benefit to Alberta businesses. LLCs allow businesses that function as partnerships to be treated as such at law, without foregoing limited liability. They provide a simple and flexible structure that gives members greater control over their business. Unanimous shareholder agreements may replicate some of these benefits. However, a need may remain for a small business-oriented entity.

The US tax benefits of LLCs are less clear. The IRS does not treat Canadian LLCs in the same manner as American LLCs. The only way to achieve desirable US tax results from Canadian operations is to use an unlimited liability Canadian entity. Ironically, limited liability companies may provide a desirable structure for US tax planners in need of an unlimited liability Canadian entity.

TABLE OF CONTENTS

Part I - Introduction 1

Part II - What is an LLC 2
1. Structure
2. Creation
3. Limited Liability
4. Other Partnership Characteristics
5. Fixed Duration
6. Duties
7. Remedies
8. Dissociation, Dissolution & Wind-up
9. Tax Treatment

Part III - LLCs for Alberta Businesses 6
A. Would Alberta Businesses Benefit from LLCs
B. Associated Issues
    1. Should Oral Operating Agreements be Permitted
    2. Protection of Minority Member Rights
    3. Protection of Creditors' Rights
C. Existing Alternatives to LLCs
    1. Unanimous Shareholder Agreements
    2. Limited Partnerships
    3. Limited Liability Partnerships
Questions for Feedback

Part IV - LLCs for American Businesses 9
A. US Tax Needs of American Businesses Operation in Alberta
B. Possible US Tax Solutions
    1. Create LLCs that Can Opt to be Unlimited Liability Companies
    2. Permit Corporations to Opt to be Unlimited Liability Companies
    3. Continue to use Nova Scotia Unlimited Liability Companies
    4. Extra-Provincial Registration of Foreign LLCs
Questions for Feedback

Part V - Registration Requirements 11

A. Creating an LLC
    1. Articles of Organization
    2. Business Name Restrictions
B. Operations and Reporting
    1. Operating Agreement
    2. Annual Return
C. Fundamental Changes
    1. Amending Articles
    2. Dissociation
    3. Merger
    4. Termination
Questions for Feedback

Appendix A - Tax Treatment Summary **A-1**

Appendix B - Background on Unlimited Liability Companies **B-1**

Appendix C - 26 CFR s. 301.7701-2 & s. 7701.3 **C-1**

Appendix D - Interpretation Bulletin IT-343R **D-1**

Appendix E - Entity Comparison Chart **E-1**

Part I - Introduction

The purpose of this discussion paper is to consider whether there is a need to create limited liability companies ("LLC") in Alberta. The potential need for this legislation was raised by the Corporate Commercial Advisory Committee of the Law Society of Alberta.

The need for LLC legislation has been suggested based on two grounds. First, LLC legislation could provide a more flexible business vehicle for closely held Canadian controlled Alberta companies. Second, LLC legislation may address the US tax concerns of American corporations that carry on business in Alberta. The purpose of this paper is to explore whether LLC legislation will fulfill either of these goals.

This paper begins by giving a descriptive account of limited liability companies (Part II). To discuss the benefits of LLCs and alternatives to the use of LLCs, the paper is divided into the following components: Part III examines LLCs from the point of view of Alberta businesses. Part IV examines LLCs from the perspective of American businesses. Lastly, Part V discusses potential registration requirements for LLCs. Throughout the paper, questions on which feedback is requested are noted and summarized at the end of the Part in which they arise.

This paper is intended to identify different lines of reasoning that may need to be considered in assessing the merits of LLC legislation. It is hoped that this document will serve as a starting point for discussion as to whether LLC legislation should be enacted and, if so, what general form it should assume.

This paper was written by Lloyd McLellan, in the course of his 1999 summer employment with Alberta Registries. Lloyd is currently a third year student at the University of Alberta Law School.

All stakeholders are invited to express their views on issues raised by this paper and the general goals sought to be achieved through limited liability company legislation.

This discussion paper and summary of questions are available on the Internet at www.gov.ab.ca/ma/reg/discussion1.htm

Please send your comments by February 28, 2000 either **electronically to discussionpapers@reg.gov.ab.ca** or via mail to:

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Part II - What is an LLC

A limited liability company is a business entity that combines the most attractive attributes of partnerships and corporations. Limited liability companies provide the flexible structure of a partnership with the limited liability of a corporation.

There is no federal or provincial LLC legislation in place in Canada. Conversely, almost every American state has unique legislation in place to provide for LLCs. Two organizations have drafted model legislation to attempt to promote uniformity in this area. The American Bar Association created the *Prototype Limited Liability Company Act* ("ABA Model") in 1992 and the National Conference of Commissioners on Uniform State Laws drafted the *Uniform Limited Liability Company Act* ("Uniform Act") in 1996.

The Uniform Act, ABA Model and much of the state legislation is very similar in principle. There are substantive differences to the extent that some states have adjusted their legislation to the latest US tax rulings. These differences are not relevant to this general discussion paper.

The Uniform Act serves as the basis for this paper's description of common LLC characteristics. The remainder of this Part describes the key elements of the LLC. Refer to Appendix E for a chart that compares the LLC to other business vehicles.

1. Structure

A limited liability company is very similar to a partnership. LLCs are governed by legislation that provides very basic rules as to how "members" are to treat one another. These are default rules that contemplate agreement between the members that will alter the terms of their relationship. For example, LLC legislation, like partnership legislation has default rules saying that all members are to receive an equal share of the entity's profits. The members or partners will often agree to change this default rule.

LLC and partnership legislation is enabling legislation that puts a skeletal framework in place. Members or partners will make their own rules regarding such matters as share transfer restrictions, the division of profits and the holding of meetings.

Whereas partnerships usually have a partnership agreement, LLCs normally have an *operating agreement* that sets out the terms of the members' relationship. The Uniform Act provides that the operating agreements may be oral or written. To amend the operating agreement requires the unanimous consent of all members. If there is a conflict between the operating agreement and the articles of organization (discussed below), then the operating agreement governs with respect to internal matters and the articles are paramount in disputes with external parties.

2. *Creation*

The steps required to organize an LLC are more similar to those required with a corporation than a partnership. Individuals can be partners and subject to the *Partnership Act* by the simple fact that they are "acting in common with a view to profit." Conversely, active steps must be taken to create an LLC. Typically, jurisdictions that allow for the creation of LLCs require that *articles of organization* be filed with the government. These articles set out the name and address of the LLC, the organizers, any limits on the duration, any "managers" and whether the members are to be liable for the debts of the LLC. LLCs essentially have to register their existence with the government in the same way as corporations must be registered by filing articles of incorporation and annual reports. The registration requirements for LLCs will be discussed in detail in Part V.

3. *Limited liability*

The unique aspect of LLCs is that they offer limited liability, notwithstanding their partnership structure. An LLC is a legal entity distinct from its members. Members are generally not liable for the debts or obligations of the LLC. Members are only liable for the amount that they have agreed to contribute to the LLC.

The Uniform Act model allows members to elect to assume liability for the company's debts. Ironically, in some cases a so-called *limited* liability company will in fact be an *unlimited* liability company. This is only relevant insofar as it relates to US tax issues, as discussed in Appendix B.

4. *Other Partnership Characteristics*

LLCs usually possess other attributes that are characteristic of partnerships, such as decentralized management and restrictions on transfer. An LLC may be managed by the members or by managers hired by them. In either case, each of the managers (whether they are members or not) have equal voting rights unless the operating agreement specifies otherwise. A majority of managers may decide any matter relating to the business of the LLC, with the exception of certain major changes that require the unanimous consent of all members.

Members and managers are agents of the LLC. They can bind the LLC if they are acting in the ordinary course of business of the LLC with actual or apparent authority. The apparent authority of an agent does not bind the LLC where notice has been given of an agent's lack of actual authority.

A member is free to transfer his or her right to receive distributions. Voting and other management rights can only be transferred if the operating agreement allows the transfer or if all members consent. To transfer these rights amounts to

the admission of a new member, so unanimous consent of the members is required.

5. *Fixed Duration*

An LLC usually only exists for a fixed term which is set out in the articles. However, the organizers need not set a term. If a term is not set or improperly set or the business continues after the term expires, then the LLC will be treated as an "at will" company.

Generally, the Act still applies to at-will companies but it may not apply in some specific cases. For example, if a member dissociates from an at-will company then the company dissolves unless a sufficient percentage of the other members agree to continue. Conversely, a term company only dissolves upon the occurrence of certain specified events. A dissociated member of a term company must wait until the expiration of the term to have his or her shares redeemed by the company.

6. *Duties*

A member or manager owes a "duty of loyalty" and a "duty of care" to the company. The duty of loyalty requires that the member account to the LLC for a profit derived from the company's property or opportunities. It prevents a member from competing with the company or acting on behalf of other parties in dealings with the LLC. The general duty of care owed to the company creates an obligation to act competently in managing the affairs of the company. This obligation is measured against a gross negligence standard.

A member or manager may also be liable to the company for excessive distributions. If one votes in favour of distributing funds or receives funds when the company is insolvent then they may be liable to the company for the amount that the company cannot afford to distribute.

7. *Remedies*

A member may take personal action against the company or other members to enforce his or her rights under the Act or the operating agreement.

A member may also initiate a derivative action in the name of the company if members or managers refuse to pursue an action or if efforts to cause them to take such action are unlikely to succeed.

8. *Dissociation, Dissolution & Wind-up*

A member will be dissociated from the company in several cases. This may occur upon appropriate notice, death, bankruptcy, transfer of one's entire interest

or unanimous vote of the members. Usually the operating agreement will set out other triggering events in addition to those for which the Act provides.

The company must purchase the dissociated member's interest for fair market value. It must do so immediately if it is an "at-will" company. If it is a term company then it need only repurchase the interest at the expiration of the term.

An "at-will" company will usually dissolve upon the dissociation of a member. A term company will continue after dissociation if the number of members required by an operating agreement vote in favour of continuing. The operating agreement may also contemplate dissolution upon the occurrence of specified triggering events or a vote in favour of dissolution.

A company must also be dissolved if it becomes unlawful to continue the business of the company. Alternatively, a member, dissociated member or transferee of a member's interest may apply to a court to have the company dissolved if the conduct of the company or members so requires.

After dissolution but before wind-up, an agent may still bind the LLC if no notice is given of the dissolution. The agent may be liable to the LLC if they have knowledge of the dissolution. Upon wind-up, the creditors are first to recover, and the remainder is distributed to the members.

9. Tax Treatment

Alberta businesses are not expected to gain any tax advantage from using an LLC. American businesses operating in Alberta might prefer to use an LLC for tax purposes. For a detailed discussion of the tax issues surrounding LLCs, please refer to Appendix A and Appendix B.

Part III - LLCs for Alberta Businesses

A. Potential Benefit to Alberta Businesses from LLCs

The LLC would probably be most attractive to small closely held companies that carry on business through a corporation. The *Business Corporations Act* ("BCA") sets out very detailed rules and procedures with which corporations must comply. Although there are some exemptions, generally these are mandatory rules. For example, a corporation must have a certain number of directors and meetings must be called within a specified time frame.

In contrast, LLC legislation imposes very few mandatory rules. Like partnership legislation, it is enabling in nature. Once the basic requirements are satisfied, the members have the freedom to make their own rules as to how they will deal with one another. The members can decide how profits will be shared, when and where they will meet, who will manage the business and they can create their own procedures for deciding such matters.

These benefits have always been available to parties to a partnership. However, this flexibility has always required that the parties forego the benefit of limited liability. The primary benefit of LLCs is that they provide this flexibility and they limit the liability of the members. It is anticipated that if LLCs are created then liability issues will no longer drive the decision between business vehicles. Individuals will be free to choose a business vehicle that suits the size and nature of their business

B. Associated Issues

1. Permission for Oral Operating Agreements

LLC members may enjoy the entity's flexibility but the informal structure could cause problems. Uniform Act s. 103(a) provides that an operating agreement need not be in writing to be enforceable. This could naturally lead to many disputes as to the terms of such an agreement.

2. Protection of Minority Member Rights

The flexible structure of the LLC may not be appropriate for more widely held entities. Although LLC legislation is flexible, it also relies on a system that allows the majority to make most decisions. Where there are many members, those who have made relatively small contributions to the company may not have any effective say in the company's decisions. Furthermore, it may simply be difficult to reach agreement where there are too many decision makers.

Where there are too many members, it may be preferable to use a corporation such that there will be mandatory rules and procedures that must be followed.

The BCA also provides tools such as the oppression remedy that will help to protect minority shareholders.

3. Protection of Creditors' Rights

It is important to consider the impact of LLCs on the rights of parties dealing with LLCs, such as creditors. There are several aspects of LLC legislation that may operate to prejudice the rights of creditors. If the liability of the members is limited then creditors can only seek to recover debts from the LLC. It is important that the members or managers act in the best interests of the LLC and not in their personal interests.

Therefore, it may be of concern to creditors that the Uniform Act is more lenient in imposing duties on the members than a corporation. It imposes a duty of loyalty and a duty of care (see Part II). This resembles the duties imposed on officers and directors by the BCA. However, the duty of care is only assessed at a gross negligence standard. Furthermore, these duties are qualified by provisions like s. 409(e) which say that one is not violating their duty merely because their conduct furthers their personal interests. These less onerous duties may leave room for managers or members to appropriate company opportunities for their personal advantage or to be less diligent in attending to the affairs of the company.

A third component of this matter is that only members have the right to initiate a derivative action under Uniform Act s. 1101. A derivative action allows one to take action in the name of the company if the members or managers of the company refuse to take that action. A derivative action may be used where managers have violated their duty to the company, to the detriment of the company but will not direct the company to take action against themselves.

Conversely, under the BCA, anyone (e.g. creditors) may apply to a court to be granted the right to commence an action in the name of the corporation.

C. Existing Alternatives to LLCs

1. Unanimous Shareholder Agreements

The LLC offers a more flexible structure that allows members the freedom to function as a partnership without sacrificing limited liability. Flexibility with respect to the internal affairs of the entity could alternatively be obtained with a corporation and a unanimous shareholder agreement ("USA"). This is not a perfect substitute. There are more constraints on a USA than an operating agreement. Furthermore, a USA merely shifts many of the duties from directors to the shareholders. It does not obviate the need to comply with these duties as an operating agreement may provide.

The LLC and operating agreement concept may also be preferable to using USAs and corporations because it would allow companies to move away from corporate law concepts that have put more strict constraints on the use of USAs. Notwithstanding the limitations on USAs, they may provide sufficient flexibility for the typical Alberta small business.

2. *Limited Partnerships*

A limited partnership (LP) would provide the same structure as an LLC but it has some major drawbacks. There must be a general partner who is liable for the debts of the partnership. Secondly, the limited partners cannot actively participate in the affairs of the partnership or they will be treated as general partners. If the members were going to hire managers anyway and if the general partner was a corporation, then perhaps the LP would be an alternative to the LLC.

3. *Limited Liability Partnerships*

Amendments to the *Partnership Act* that will be in force later this year will allow for the creation of limited liability partnerships (LLPs). Partners of an LLP will only be liable for their own negligence and not that of their partners. LLPs will not be a substitute for LLCs, because LLPs may only be used by specified professionals who would not likely be permitted to use LLCs. If anyone were permitted to use LLPs, then there may be less need for LLCs.

Questions For Feedback

1. **Would closely held Alberta businesses prefer the flexible structure of an LLC to that of a corporation?**

2. **Should an Alberta LLC Act require that operating agreements be written?**

3. **Should LLCs be restricted to a particular number of members?**

4. **Would any of the following attributes of LLCs be unduly prejudicial to creditors: limited liability, more lenient duties, no derivative actions?**

5. **Would an LLC with an operating agreement provide greater flexibility than a corporation and a unanimous shareholder agreement?**

6. **Under what circumstances would an LP or LLP be preferable to an LLC?**

Part IV - LLCs for American Businesses

A. US Tax Needs of American Businesses Operating in Alberta

American companies carrying on business in Alberta may want to use an LLC for US tax reasons. They would like the gains or losses of their Canadian operations to be reflected on the US tax returns that they file with the IRS. For example, if they lose money on their Canadian operations, they would like to be able to use those losses to offset their US earnings so that they will owe less US tax. The difficulty is that the IRS will only allow the gains or losses of certain entities to "flow-through" to US returns.

Traditionally, partnerships have had this "flow-through" status and corporations have not. American LLCs are treated as partnerships by the IRS because of their unique mix of characteristics. Canadian LLCs are treated as corporations by the IRS, without any apparent policy justification for the different treatment. The only type of Canadian entity that will be treated as a partnership by the IRS is an unlimited liability entity. Ironically, the IRS requires that Americans use an *unlimited* liability company in Canada to receive the same treatment as a *limited* liability company would receive in the United States. For a more detailed discussion of the development of this state of affairs, please refer to Appendix B.

B. Possible US Tax Solutions

1. Create LLCs that can Opt to be Unlimited Liability Companies

LLCs per se do not appear to offer any US tax benefits. Perhaps the LLC structure could be used with a provision that allows the members to opt to assume liability for the company. The Uniform Act has such an option in s. 303(c). Therefore, the entity could in fact be an LLC or a Unlimited Liability Company depending on the needs of the members. The default treatment would be limited liability for the benefit of Canadian businesses. Americans could opt for unlimited liability to satisfy their tax needs. The entities would be the same in every other respect.

2. Permit Corporations to Opt to be Unlimited Liability Companies

The BCA could be amended to allow shareholders the option of assuming liability for a corporation's debts. This may be undesirable as it would mix contractarian elements with a division of powers model. However, this possibility may have many practical benefits. Everyone is comfortable in using BCA model entities. This would also eliminate the potential for great uncertainty with the use of LLCs.

3. Continue to Use Nova Scotia Unlimited Liability Companies

The current practice is to incorporate under the *Nova Scotia Companies Act* if an American company would like "flow-through" treatment by the IRS. Section 9 of the Act allows the members of the company to elect to assume liability for the company's debts.

4. Extra-Provincial Registration of Foreign LLCs

Part 21.1 of the BCA allows for the registration in Alberta of extra-provincial entities, such as LLCs. Instead of creating Alberta legislation to suit the needs of American firms, perhaps they can simply import desirable aspects of their home legislation into their Canadian operations.

Firms from other jurisdictions wishing to carry on business in Alberta may prefer to use an Alberta entity. They may prefer this structure to avoid the requirement that the entity comply with regulations in two jurisdictions. For example, if an American business used an Alberta LLC rather than registering an American LLC in Alberta, they may avoid anti-trust restrictions or the duplication of industry-specific regulations. An additional consideration is that an American corporation registered in Canada would be subject to branch tax by Revenue Canada.

Questions for Feedback

7. **Should LLC legislation allow organizers to designate whether the members' liability will be limited or unlimited?**

8. **Are there undesirable consequences that may result from creating entities that allow for too much flexibility?**

9. **Should the BCA be amended to allow shareholders to assume liability for a corporation?**

10. **To what extent does extra-provincial registration of foreign LLCs resolve the concerns of American firms?**

Part V - Registration Requirements

If it is determined that there is a need for LLC legislation, it will be important to consider the practicalities of how they will be formed and recognized. This Part will give a general overview of how LLCs could be registered.

A. Creating an LLC

1. Articles of Organization

To initially register an LLC, the uniform US models generally only require the company to file articles of organization with the Registrar and to pay a fee. The larger question is what items should be required to be included in the articles. The Uniform Act requires that the following items be included in the articles:

(a) name of the company
(b) address of initial designated office
(c) name and street address of initial agent for service of process
(d) name and address of each organizer
(e) whether the company is to be a term company and, if so, the term specified
(f) whether the company is to be manager-managed, and, if so, the name and address of each initial manager
(g) whether one or more of the members of the company are to be liable for its debts and obligations

Item (e) may not be necessary. It is no longer of any benefit under US tax laws since the change to the "check the box" system (see Appendix B). Nor would it be of any apparent benefit to a Canadian controlled firm.

Item (g) above would allow members to assume unlimited liability if it would be desirable to do so pursuant to US tax laws. Canadian controlled firms could simply ignore that element and the default would be that the members would have limited liability.

It is also important to note that the Uniform Act model only requires that non-member managers be identified by name and address in the articles (item (f)). Perhaps there should be a requirement that all members be identified in the articles. If the LLC is member-managed then the members would owe a duty of loyalty and a duty of care to the LLC. Even if the LLC has managers, members still owe these duties to the extent that they choose to participate in the operations of the LLC. If one owes a duty to the LLC, then perhaps that person should be identified so they will be accountable to creditors and others who are affected by the solvency of the company.

2. Business Name Restrictions

Another initial issue to consider are the constraints to be imposed on LLC names. It would probably be desirable to require that LLC be subject to the same type of name restrictions included in the BCA and Business Corporations Regulations to ensure that they are not confused with any existing businesses. Furthermore, the unique legal status of the LLC would warrant a requirement that LLCs include the abbreviation "LLC" after the distinctive element of their name. Is there any reason to treat LLCs differently than corporations with regard to business name provisions.

B. Operations & Reporting

1. Operating Agreement

The Uniform Act and other American models do not require that the operating agreement be filed with the Registrar. The standard is that no operating agreement need even be made and if there is no such agreement then the default rules of the Act govern.

2. Annual Return

Typically, other models require the following items to be included in an LLC annual return:

a. name of company
b. address of designated office and the name and address of its agent for service of process
c. address of its principal office
d. names and business addresses of any managers

This raises the same issues as are being discussed in relation to the BCA. Perhaps more detailed information should be included in the annual return to advise third parties of the solvency of the entity. In relation to corporate annual returns the weight of opinion seems to be in favour of short form annual returns.

C. Fundamental Changes

1. Amending Articles

The articles of organization may be amended by filing articles of amendment with the Registrar that state the name of the company, the date and the amendment to be made. Such an amendment requires the unanimous consent of all members unless the operating agreement provides otherwise.

2. Dissociation

A dissociated member may file a statement indicating the name of the LLC and that they are dissociated. Typically, model legislation provides that such a filing is to serve as deemed notice of that person's dissociation so their actions will no longer bind the company.

3. Merger

An LLC may merge with other LLCs or other entities by filing articles of merger with the Registrar. This would have to include the plan of merger and detailed information on the parties to the agreement. Articles of merger would function as an amendment to the LLC's articles of organization.

4. Termination

Based on the Uniform Act, a company could file articles of termination to terminate the company after dissolution and windup. The articles of termination would simply state the name of the LLC, the date, that the company has been wound up and that the legal existence of the company is terminated.

Questions for Feedback

11. **Would there be any advantage or disadvantage in allowing organizers to fix the existence of the LLC to a specific term?**

12. **Should the names and addresses of members have to be set out in the articles?**

13. **Should business name provisions be substantively different for LLCs than they are for corporations?**

14. **Should LLCs be held to more onerous disclosure requirements than corporations?**

1. Canadian resident corporation

A corporation resident in Canada that is controlled by Americans will be taxed by Revenue Canada. The IRS will treat this corporation as a "controlled foreign corporation." It will tax distributions made from the corporation to the American shareholders pursuant to Subpart F of the Internal Revenue Code. Revenue Canada will assess a withholding tax on these distributions for which the IRS will give the American shareholders a partial tax credit.

2. Partnership carrying on business in Canada

The income or loss of a partnership carrying on business in Canada will be taxed by Revenue Canada as long as that partnership has a permanent establishment in Canada. Distributions to the American partners will be assessed a withholding tax which will be credited toward the tax owing by the partners to the IRS.

3. Canadian LLC

A Canadian LLC would probably be taxed as a corporation by Revenue Canada. Interpretation Bulletin IT-343R (see Appendix D-1) indicates that the term corporation includes all entities that have

> *a legal personality and existence separate and distinct from the personality and existence of those who caused its creation or owned it.*

This definition is meant to apply for the purposes of the ITA s. 95(1)(d) definition of "foreign affiliate." This means that Revenue Canada will treat foreign LLCs as corporations. The same reasoning would probably apply to Canadian LLCs, such that they would also be treated as corporations.

If the Canadian LLC were American controlled, it would be treated as a corporation by the IRS pursuant to 26 CFR s. 301.7701.2(8)(i) (see Appendix C-2) which deems Canadian companies or corporations to be corporations for US tax purposes.

4. Canadian unlimited liability entity

Nova Scotia Companies are taxed as corporations by Revenue Canada. It is not clear whether Canadian (or American) LLCs that have opted for unlimited liability would be treated as a corporation or as a partnership. Apparently, IT-343R does not apply to treat Canadian LLCs as corporations if the members of the LLC have elected to assume unlimited liability.

A corporation possesses its own capacity to acquire rights and to assume liabilities, and any rights acquired or liabilities assumed by it are not the rights or liabilities of those who control or own it.

If liability is unlimited then it is less clear whether the "LLC" is really a distinct legal entity. In some circumstances it may be desirable to have Revenue Canada treat the entity as a partnership but in other cases, such as with corporate reorganizations, it is critical that the entity be treated as a corporation. In any event, the fact of the uncertainty is a perhaps greater problem then how they will actually be treated.

The IRS treatment is much more clear. The unlimited liability entity would have the option of being treated as a partnership or as a corporation by the IRS if the members elected to assume unlimited liability. Section 7701.2(8)(ii)(A) of the regulations to the Internal Revenue Code makes this exception for unlimited liability Canadian entities. (see Appendix C-3)

As a result, Revenue Canada would tax any earnings of the entity as a corporation. However, the American shareholders would likely elect to have the entity treated as a partnership by the IRS such that any earnings or losses would flow through to their US tax returns.

5. Problems with Uncertainty

IT-343R only applies to foreign LLCs. It is not determinative with respect to Canadian LLCs. Nor does it specifically address the treatment of an unlimited liability "LLC." The general treatment of LLCs could have many tax ramifications. For example, would Canadian LLCs qualify for the annual $200,000 small business deduction pursuant to ITA s. 125? This is important to consider since LLCs are designed to be structurally attractive to closely held Alberta businesses. This is just one example of a case where the uncertain tax treatment of the LLC would affect the willingness of entrepreneurs to use the entity.

Presumably, the treatment of Canadian LLCs will be consistent throughout the Act once the entity's tax status is determined. However, uncertainty would remain where LLCs and corporations are structurally different. For example, the application of any provision referring to directors, dividends or the stated capital account would be in doubt. This type of uncertainty may inhibit the use of LLCs.

APPENDIX B
BACKGROUND ON UNLIMITED LIABILITY COMPANIES

The initial purpose of American LLC legislation was to allow businesses to be taxed as partnerships without losing the limited liability feature of corporations. The first LLC Act was created in Wyoming in 1977, before the IRS or the courts had formulated a test to determine whether an LLC would be taxed as a partnership or as a corporation.

In 1988, the IRS ruled (Rev. Rul. 88-76) that a Wyoming-style LLC would be taxed as a partnership. As a result, most states very quickly passed legislation allowing for LLCs that passed the IRS test for partnership tax treatment.

The IRS initially required that an entity have no more than two of four "corporate characteristics." Those characteristics being; limited liability, continuous life, central management and unrestricted transfer. American LLC legislation typically provided limited liability but avoided the other three factors to ensure partnership tax treatment.

LLCs did not exist in Canada so American companies looked for alternative Canadian entities that would pass the IRS test for partnership treatment. Nova Scotia Companies became the entity of choice because s. 9 of the *Nova Scotia Companies Act* allowed members to elect to assume liability for the debts of the company. Unlimited liability was seen by the IRS as a characteristic of partnerships. This feature made it possible for Nova Scotia Companies, quite by accident, to qualify as partnerships with the IRS.

If the 1988 IRS ruling was still the relevant test then an Alberta LLC could pass that test in the same manner as state LLC legislation. There would be no need to provide unlimited liability. The complication is that the IRS has changed its position many times on how entities will be classified for tax purposes since the initial four factor ruling that led to the creation of LLCs. In doing so, the IRS has "closed the door" on Canadian LLCs and made a specific exception for the peculiar manner by which Nova Scotia Companies were granted partnership tax status in the past.

The new "check the box" regulations to the Internal Revenue Code that came into force on January 1, 1997 allowed most US entities to choose whether they would be taxed as partnerships or as corporations. According to 26 CFR s. 301.7701.3, this choice is available to "eligible" entities.

However, some entities are not eligible to make this choice. The IRS deems that they are to be taxed as corporations. Section 7701.2(8)(i) lists those entities that fall within that category. This list includes "Canada, corporation or company" (see Appendix C-2). This means that an Alberta LLC would be treated as a corporation by the IRS.

The widespread use of Nova Scotia unlimited liability companies resulted in an exception being made to this provision. Section 7701.2(8)(ii)(A) provides that a Canadian entity will be an eligible entity if it is "formed under any federal or provincial law which provides that the liability of all of the members ... will be unlimited" (see

Appendix C-3). The historical use of the *Nova Scotia Companies Act* has been entrenched in US tax regulations.

The result of the changes to US tax regulations is that an Alberta entity will only attain US partnership tax status if it has unlimited liability. The reference to "Canada, corporation or company" implies that an Alberta LLC that is strictly based on US LLC legislation would be treated as a "controlled foreign corporation" by the IRS. There is no apparent policy reasoning to support this distinction. However, the current result is that American firms would likely only be interested in an unlimited liability Alberta entity.

[Code of Federal Regulations]
[Title 26, Volume 17, Parts 300 to 499]
[Revised as of April 1, 1997]
From the U.S. Government Printing Office via GPO Access
[CITE: 26CFR301.7701-2]

[Page 503-505]

TITLE 26--INTERNAL REVENUE

CHAPTER I--INTERNAL REVENUE SERVICE, DEPARTMENT OF THE TREASURY--(Continued)

Definitions--Table of Contents

Sec. 301.7701-2 Business entities; definitions.

(a) Business entities. For purposes of this section and Sec. 301.7701-3, a business entity is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under Sec. 301.7701-3) that is not properly classified as a trust under Sec. 301.7701-4 or otherwise subject to special treatment under the Internal Revenue Code. A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership. A business entity with only one owner is classified as a corporation or is disregarded; if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner.

(b) Corporations. For federal tax purposes, the term corporation means--

(1) A business entity organized under a Federal or State statute, or under a statute of a federally recognized Indian tribe, if the statute describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic;

(2) An association (as determined under Sec. 301.7701-3);

(3) A business entity organized under a State statute, if the statute describes or refers to the entity as a joint-stock company or joint-stock association;

(4) An insurance company;

(5) A State-chartered business entity conducting banking activities, if any of its deposits are insured under the Federal Deposit Insurance Act, as amended, 12 U.S.C. 1811 et seq., or a similar federal statute;

(6) A business entity wholly owned by a State or any political

subdivision thereof;

(7) A business entity that is taxable as a corporation under a provision of the Internal Revenue Code other than section 7701(a)(3); and

(8) Certain foreign entities--(i) In general. Except as provided in paragraphs (b)(8)(ii) and (d) of this section, the following business entities formed in the following jurisdictions:

American Samoa, Corporation
Argentina, Sociedad Anonima
Australia, Public Limited Company

[[Page 504]]

Austria, Aktiengesellschaft
Barbados, Limited Company
Belgium, Societe Anonyme
Belize, Public Limited Company
Bolivia, Sociedad Anonima
Brazil, Sociedade Anonima
Canada, Corporation and Company
Chile, Sociedad Anonima
People's Republic of China, Gufen Youxian Gongsi
Republic of China (Taiwan), Ku-fen Yu-hsien Kung-szu
Colombia, Sociedad Anonima
Costa Rica, Sociedad Anonima
Cyprus, Public Limited Company
Czech Republic, Akciova Spolecnost
Denmark, Aktieselskab
Ecuador, Sociedad Anonima or Compania Anonima
Egypt, Sharikat Al-Mossahamah
El Salvador, Sociedad Anonima
Finland, Osakeyhtio/Aktiebolag
France, Societe Anonyme
Germany, Aktiengesellschaft
Greece, Anonymos Etairia
Guam, Corporation
Guatemala, Sociedad Anonima
Guyana, Public Limited Company
Honduras, Sociedad Anonima
Hong Kong, Public Limited Company
Hungary, Reszvenytarsasag
Iceland, Hlutafelag
India, Public Limited Company
Indonesia, Perseroan Terbuka .....

(ii) Exceptions in certain cases. The following entities will not be treated as corporations under paragraph (b)(8)(i) of this section:

(A) With regard to Canada, any corporation or company formed under any federal or provincial law which provides that the liability of all of the members of such corporation or company will be unlimited; and

* * *

(d) Special rule for certain foreign business entities--(1) In general. Except as provided in paragraph (d)(3) of this section, a foreign business entity described in paragraph (b)(8)(i) of this section will not be treated as a corporation under paragraph (b)(8)(i) of this section if--

(i) The entity was in existence on May 8, 1996;

(ii) The entity's classification was relevant (as defined in Sec. 301.7701-3(d)) on May 8, 1996;

(iii) No person (including the entity) for whom the entity's classification was relevant on May 8, 1996, treats the entity as a corporation for purposes of filing such person's federal income tax returns, information returns, and withholding documents for the taxable year including May 8, 1996;

(iv) Any change in the entity's claimed classification within the sixty months prior to May 8, 1996, occurred solely as a result of a change in the organizational documents of the entity, and the entity and all members of the entity recognized the federal tax consequences of any change in the entity's classification within the sixty months prior to May 8, 1996;

(v) A reasonable basis (within the meaning of section 6662) existed on May 8, 1996, for treating the entity as other than a corporation; and

(vi) Neither the entity nor any member was notified in writing on or before May 8, 1996, that the classification of the entity was under examination (in which case the entity's classification will be determined in the examination).

(2) Binding contract rule. If a foreign business entity described in paragraph (b)(8)(i) of this section is formed after May 8, 1996, pursuant to a written binding contract (including an accepted bid to develop a project) in effect on May 8, 1996, and all times thereafter, in which the parties agreed to engage (directly or indirectly) in an active and substantial business operation in the jurisdiction in which the entity is formed, paragraph (d)(1) of this section will be applied to that entity by substituting the date of the entity's formation for May 8, 1996.

(3) Termination of grandfather status--(i) In general. An entity that is not treated as a corporation under paragraph (b)(8)(i) of this section by reason of paragraph (d)(1) or (d)(2) of this section will be treated permanently as a corporation under paragraph (b)(8)(i) of this

section from the earliest of:

(A) The effective date of an election to be treated as an association under Sec. 301.7701-3;

(B) A termination of the partnership under section 708(b)(1)(B) (regarding sale or exchange of 50 percent or more of the total interest in an entity's capital or profits within a twelve month period); or

(C) A division of the partnership under section 708(b)(2)(B).

(ii) Special rule for certain entities. For purposes of paragraph (d)(2) of this section, paragraph (d)(3)(i)(B) of this section shall not apply if the sale or exchange of interests in the entity is to a related person (within the meaning of sections 267(b) and 707(b)) and occurs no later than twelve months after the date of the formation of the entity.

(e) Effective date. The rules of this section are effective as of January 1, 1997.

[T.D. 8697, 61 FR 66589, Dec. 18, 1996]

Sec. 301. 7701-3 Classification of certain business entities.

(a) In general. A business entity that is not classified as a corporation under Sec. 301. 7701-2(b) (1), (3), (4), (5), (6), (7), or (8) (an eligible entity) can elect its classification for federal tax purposes as

[[Page 506]]

provided in this section. An eligible entity with at least two members can elect to be classified as either an association (and thus a corporation under Sec. 301. 7701-2(b)(2)) or a partnership, and an eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner. Paragraph (b) of this section provides a default classification for an eligible entity that does not make an election. Thus, elections are necessary only when an eligible entity chooses to be classified initially as other than the default classification or when an eligible entity chooses to change its classification. An entity whose classification is determined under the default classification retains that classification (regardless of any changes in the members' liability that occurs at any time during the time that the entity's classification is relevant as defined in paragraph (d) of this section) until the entity makes an election to change that classification under paragraph (c)(1) of this section. Paragraph (c) of this section provides rules for making express elections. Paragraph (d) of this section provides special rules for foreign eligible entities. Paragraph (e) of this section

provides special rules for classifying entities resulting from partnership terminations and divisions under section 708(b). Paragraph (f) of this section sets forth the effective date of this section and a special rule relating to prior periods.

(b) Classification of eligible entities that do not file an election--(1) Domestic eligible entities. Except as provided in paragraph (b)(3) of this section, unless the entity elects otherwise, a domestic eligible entity is--

(i) A partnership if it has two or more members; or

(ii) Disregarded as an entity separate from its owner if it has a single owner.

(2) Foreign eligible entities--(i) In general. Except as provided in paragraph (b)(3) of this section, unless the entity elects otherwise, a foreign eligible entity is--

(A) A partnership if it has two or more members and at least one member does not have limited liability;

(B) An association if all members have limited liability; or

(C) Disregarded as an entity separate from its owner if it has a single owner that does not have limited liability.

(ii) Definition of limited liability. For purposes of paragraph (b)(2)(i) of this section, a member of a foreign eligible entity has limited liability if the member has no personal liability for the debts of or claims against the entity by reason of being a member. This determination is based solely on the statute or law pursuant to which the entity is organized, except that if the underlying statute or law allows the entity to specify in its organizational documents whether the members will have limited liability, the organizational documents may also be relevant. For purposes of this section, a member has personal liability if the creditors of the entity may seek satisfaction of all or any portion of the debts or claims against the entity from the member as such. A member has personal liability for purposes of this paragraph even if the member makes an agreement under which another person (whether or not a member of the entity) assumes such liability or agrees to indemnify that member for any such liability.

(3) Existing eligible entities--(i) In general. Unless the entity elects otherwise, an eligible entity in existence prior to the effective date of this section will have the same classification that the entity claimed under Secs. 301, 7701-1 through 301,7701-3 as in effect on the date prior to the effective date of this section; except that if an eligible entity with a single owner claimed to be a partnership under those regulations, the entity will be disregarded as an entity separate from its owner under this paragraph (b)(3)(i). For special rules regarding the classification of such entities for periods prior to the effective date of this section, see paragraph (f)(2) of this section.

(ii) Special rules. For purposes of paragraph (b)(3)(i) of this section, a foreign eligible entity is treated as being in existence

prior to the effective date of this section only if the entity's classification was relevant (as defined in paragraph (d) of this section) at any time during the sixty months prior to the effective date of this section. If an entity claimed different classifications

[[Page 507]]

prior to the effective date of this section, the entity's classification for purposes of paragraph (b)(3)(i) of this section is the last classification claimed by the entity. If a foreign eligible entity's classification is relevant prior to the effective date of this section, but no federal tax or information return is filed or the federal tax or information return does not indicate the classification of the entity, the entity's classification for the period prior to the effective date of this section is determined under the regulations in effect on the date prior to the effective date of this section.

* * *

(d) Special rules for foreign eligible entities--(1) For purposes of this section, a foreign eligible entity's classification is relevant when its classification affects the liability of any person for federal tax or information purposes. For example, a foreign entity's classification would be relevant if U.S. income was paid to the entity and the determination by the withholding agent of the amount to be withheld under chapter 3 of the Internal Revenue Code (if any) would vary depending upon whether the entity is classified as a partnership or as an association. Thus, the classification might affect the documentation that the withholding agent must receive from the entity, the type of tax or information return to file, or how the return must be prepared. The date that the classification of a foreign eligible entity is relevant is the date an event occurs that creates an obligation to file a federal tax return, information return, or statement for which the classification of the entity must be determined. Thus, the classification of a foreign entity is relevant, for example, on the date that an interest in the entity is acquired which will require a

[[Page 509]]

U.S. person to file an information return on Form 5471.

INTERPRETATION BULLETIN
SUBJECT: INCOME TAX
Meaning of the Term Corporation
NO.: IT-343R

DATE: September 26, 1977

REFERENCE: Paragraph 95(1)(d)

This Bulletin replaces and cancels Interpretation Bulletin IT-343 dated September 7, 1976.

|1. For the purpose of subdivision i of Division B of Part 1 of the |Income Tax Act a "foreign affiliate" is defined in paragraph 95(1)(d) |as being a non-resident corporation in which the taxpayer's equity |percentage is not less than 10 %. The purpose of this bulletin is to |define the term "corporation" as it applies to that paragraph.

2. A corporation is an entity created by law having a legal personality and existence separate and distinct from the personality and existence of those who caused its creation or those who own it. A corporation possesses its own capacity to acquire rights and to assume liabilities, and any rights acquired or liabilities assumed by it are not the rights or liabilities of those who control or own it. As long as an entity has such separate identity and existence, the Department will consider such entity to be a corporation even though under some circumstances or for some purposes the law may ignore some facet of its separate existence or identity.

|3. It is the view of the Department that the above definition |includes not only corporations sometimes referred to as joint stock |companies and limited liability companies but also the following |entities organized under the laws of foreign jurisdictions:

|| Aksjeselskap (A/S or A.S.) (Norway)
| Aktieselskab (A/S) (Denmark)
| Aktiebolag (Sweden)
| Aktiengesellschaft (A.G.)
| Anpartsselskab (ApS) (Denmark)
| Anstalt (Liechtenstein)
| Besloten Vennootschap met beperkte aansprakelijkheid (B.V.)

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APPENDIX E
ENTITY COMPARISON CHART

Characteristics	*Corporation*		*Partnership*			*Hybrid Entity*	
	BCA Corporation		*Partnership*	*Limited Liability Partnership (LLP)*	*Limited Partnership (LP)*	*Limited Liability Company (LLC)*	*Nova Scotia Company (NSC)*
Organization	Directors have residual authority to manage entity but shareholders may agree to assume particular responsibilities with a unanimous shareholder agreement		partnership act provides default rules mandating equality between the partners; usually partners agree to alter those default rules with a partnership agreement			very similar to partnership, default legislation contemplates "operating agreement"	contractarian model whereby shareholders rather than directors have ultimate control
Limited Liability	yes	yes	no	partners only liable for own negligence	yes, if passive limited partner but must have one general partner who is liable	usually limited but members could elect for unlimited	may choose limited or unlimited liability
Duration	no limit	no limit	no limit			may have limit	no limit
Revenue Canada Treatment	corporation is taxed and distributions to shareholders are also taxed		partnership itself not taxed; if partnership has permanent establishment in Canada then partners taxed on pro-rata share of income/loss of the partnership			US LLC - corporation Cdn LLC - probably corporation unlimited "LLC" - probably partnership	taxed as a corporation
IRS Treatment	if corporation is controlled by American taxpayers then distributions from the "controlled foreign corporation" are taxed in the hands of American shareholders as subpart F income		if partnership has permanent establishment in Canada and partners are American taxpayers then taxed on pro-rata share of income, but credit for amount paid to Revenue Canada			if elect unlimited liability then may elect to be taxed as a partnership or as a corporation per "check the box" rules, otherwise taxed as a corporation	if elect unlimited liability then may elect to be taxed as a partnership or as a corporation per "check the box" rules, otherwise taxed as a corporation